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Long-run Ranges
Donald L. Kohn

The Committee today is asked to choose annual ranges for money and debt consistent with its objectives for the economy and prices. While the ranges are wide, and movements in the aggregates are only one factor taken into account in policy decisions, the choice of the ranges and the accompanying report to Congress do give the Committee a chance to address and explain its objectives and strategy. In this regard, last July the Committee chose on a provisional basis ranges for 1991 for M2 and debt that were a half point below those for 1990, as another step toward the lower money and credit growth thought likely to be needed to move toward price stability; the M3 range was left at its 1990 specification, which already had been reduced markedly to take account of the shrinkage of the thrift industry.

The current economic situation, of course is somewhat different from what the Committee expected to confront when it established these provisional ranges in July. At this time the Committee is faced with balancing near-term concerns about the state of the economy, and longer-term desires to contain and reduce inflation. Both of these objectives may have particular implications for objectives for money and debt. The current state of the economy seems partly intertwined with credit conditions and associated money growth, while favorable long-term results on inflation will depend on the force with which the economy expands following recession, and satisfactory results in this regard may in turn be keyed by containing the associated rebound in growth of money and credit. Although the economic circumstances may be different from those envisioned seven months ago, it would appear that the ranges chosen provisionally in July still are consistent with a policy strategy that both allows for recovery and puts in place conditions that will produce modest deceleration in inflation. That is, we see these ranges as supporting the greenbook forecast of 6 percent growth in nominal GNP in 1991, given its judgement of the strength of underlying demands for goods and services.

That consistency, however, also depends on the credit situation that prevails in 1991; both the volume and channels of credit flows in 1991 are expected to be influenced by many of the same forces that operated in 1990, imparting an added degree of uncertainty to the relationships of money and credit to spending.

With credit market developments so central to financial forecasts, it might be useful to start with consideration of the debt measure. The debt of domestic nonfinancial sectors is expected to increase 6-1/2 percent in 1991, about half a point below its growth in 1990, and in the middle of its provisional 4-1/2 to 8-1/2 percent range. As in 1990, measured debt growth will be boosted relative to spending by the double counting involved with the Treasury's financing of the asset acquisitions of the RTC. Even aside from RTC borrowing, federal government debt growth is expected to accelerate this year, as the deficit is boosted by the effects of the weak economy. Credit supply restrictions as well as weak demand are apparent in the sluggish expansion of the debt of private domestic nonfederal sectors--at only 4-3/4 percent. Such slow private debt growth can support 6 percent nominal GNP growth not only because of the prominence of government spending, but also because net exports contribute importantly to that growth, and demands from abroad do not need to be supported by credit growth to domestic sectors. Nominal private domestic purchases are projected to increase a little less than 5 percent in 1991--a figure, I should note, that was incorrectly reported in the bluebook.

What credit growth does occur is expected again to be concentrated outside of depositories. We are projecting thrift assets to drop substantially, on the assumption of additional funding for RTC and even greater activity in resolving dead thrifts than last year. Bank credit also is projected to be weaker than in 1990 as a whole, extending the basic trends of the second half of the year. Banks are presumed to be under continuing pressure to restrain asset growth as their capital is eroded by loan losses and the cost of capital and other wholesale funding sources remains elevated. Consequently, total funding needs of depositories are damped, and M3 growth is projected at only 2 percent, about in line with 1990, and in the lower half of its tentative range. The recent reduction in reserve requirements is not expected to have much effect on M3: In the context of higher FDIC premiums, lower reserve requirements are not anticipated to boost overall asset growth very much or to cause much substitution of CDs or other M3 sources for nondeposit sources, except possibly at U.S. branches and agencies of foreign banks, which need not pay FDIC premiums. The combined effects of sluggish domestic private demand and borrowing relative to income, and of the continued reluctance of banks and thrifts to fund that demand, produces an even larger increase in M3 velocity in 1991 than in 1990.

As in 1990, sluggish depository credit also is expected to leave its imprint on M2, along witn continued depositor caution. M2 is projected to pick up a little under the influence of stronger income growth and the drop in interest rates in late 1990 and early 1991, including Friday's policy actions, but only to 4-1/2 percent--the middle of its provisional range. This growth is expected to be sufficient to support nominal income growth of 6 percent, producing a 1-1/2 percent rise in velocity. Relative to money demand model results, the staff forecast assumes a velocity shift of nearly the same dimensions as for 1990 as a whole, though at a slower rate than in the second half of the year.

The forecast of the velocity shift in 1991 implies that policy should not seek M2 growth in line with historical relationships to the expansion of income. Looking back over last year, it seems clear that there were forces operating in financial markets that were damping both M2 and GNP, but with greater effect on M2. Weak M2 growth was partly a signal of unanticipated contemporaneous shortfalls in income, partly a leading indicator of future economic weakness to the extent it reflected the unwillingness or inability of banks to extend credit, but also partly a velocity shift that would not show through to GNP. It will be difficult again to sort out these effects as we go through 1991. We are in uncharted waters when we try to relate M2 to credit and spending under circumstances of an unprecedented restructuring of flows through depositories. Nonetheless, deviations of M2 from expected paths can be sufficiently large to swamp the uncertainties and justify a policy response because they would be seen as giving some information about the credit process or about concurrent spending. Such quite likely was the case for the flat pattern of M2 over the past four months. And we should not rule out the possibility that rapid M2 growth in a recovery also would require some attention. In such situations, validating unusually weak or strong money by holding interest rates unchanged will produce, respectively, a tighter or easier monetary policy than desired.

As noted, M2 growth at the middle of the range is consistent with the staff greenbook forecast, so that the provisional range would leave some room on either side for surprises in spending propensities or money demand. However, as Mike showed, your projections are for somewhat less growth and inflation, and on average about 1-1/2 percentage points less nominal GNP growth. Assuming first, that your projections did not embody major interest rate movements and second, that last Friday's events would have roughly offsetting effects on your forecasts, it would appear that your outlook is more consistent with M2 growth in the lower half of the provisional range. Thus, the provisional ranges would seem to imply considerable scope for a somewhat easier policy than you had assumed, which might be welcome if you were concerned about the sluggish real economy projected. Indeed, if you were concerned that the provisional ranges themselves did not seem to call for sufficiently vigorous action to move against the economic downturn, consideration might be given to raising the ranges. One option would be to retain the M2 and debt ranges used in

1990. In effect, the long-term downtrend in monetary ranges would be suspended in the interests of fighting recession.

On the other hand, your forecasts do have somewhat less inflation on average than the staff forecast and, with a higher employment rate at the end of 1991, have in place conditions for a more rapid deceleration in the future. If the Committee wished to emphasize an objective of emerging from the current recession with greater progress toward price stability and then to build on that progress in the subsequent expansion, a further reduction in the ranges might be appropriate. In the current cyclical context, the requirement for achieving substantial, lasting reductions in inflation will be first, to avoid exerting too much stimulus in the recession, and second, to tighten in a timely manner in the recovery. A lower floor on money ranges will help with the first requirement, since it implies that the Federal Reserve is willing to tolerate slow money growth in the interval between easing in reserves markets and response in money and later economic activity. Timely tightening may be the more difficult requirement to meet, since it may imply a firming of money market conditions while there is still an appreciable margin of slack and perhaps few, if any, visible signs of accelerating inflation. A lower ceiling on money growth would help to meet this challenge because a pickup in money would approach the upper limit of the range sooner, contributing to consideration of a prompter response in terms of tightening money market conditions.

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Short-Run Policy Briefing
Donald L. Kohn

With regard to the coming intermeeting period, the key issue facing the Committee clearly is how aggressive to be in undertaking any further easing moves. The question has two dimensions in so far as the directive under consideration--first, whether to ease further at this time, and second, how to frame the instructions to the Desk about responses to incoming data, that is, the tilt in the language governing policy actions between meetings. Most of the arguments on both sides have already been voiced by various Committee members, but I thought it might be useful as background for the discussion to review the bidding.

An aggressive posture would be characterized by a further easing at this time, or at least by retaining the current asymmetrical language in the directive so that appreciable further weakness in the economy or in money and credit elicit prompt policy response. The case for such a posture is built on the sense that the risks and costs of a long and deep contraction are greater than those of a strong rebound. Both the risks and costs are seen as closely related to the health of the financial system and its effect in the price and availability of credit, as well as to the persistently gloomy attitudes of consumers and businesses, both of which may continue to affect spending propensities.

In this environment, an unusually aggressive easing of policy could be needed to improve confidence and to stimulate sufficient spend-ing through channels that do not require the immediate participation of depository institutions; these latter would include net exports induced by a lower dollar and financed outside the country, and demand from sectors that have access, directly or indirectly, to credit available at the lower interest rates in securities markets. Concerns about a tepid response to previous easings are accentuated by the behavior of the monetary aggregates, whose persistent weakness, despite persistent staff forecasts of a pickup just around the corner, suggests continued shortfalls spending and a lack of credit at depository intermediaries. If, in fact, the economy does rebound with considerable vigor, policy can be tightened at that time to head off any greater inflationary pressures.

A less aggressive policy stance might be characterized by no change in policy at this meeting and symmetrical language for the intermeeting adjustments; such language would not foreclose the possibility of policy actions to change money market conditions, only require stronger evidence than under an asymmetrical directive. The case for such a directive rests on concerns about the lags in the effects of the substantial policy easings already undertaken and about the timeliness of any subsequent tightening should it be needed. In terms of short-term interest rates, the system has eased quite sharply in the last few months, and the effects would not be expected to show up in money for a little while, and in activity for a considerable period. The dollar is at a low level, and under downward pressure. Both bond and stock markets seem to be anticipating an upturn; the failure of bond yields to decline much on balance since the last FOMC meeting, and the consequent sizable steepening of the yield curve, is as striking as the upswing in the stock market--especially since volatility measures suggest a lessening of perceived risk over this interval. The staff, once again, is predicting a strengthening of M2 growth--to 4 percent in February and 5 percent in March--but this time there are even a few weeks of sizable increases in data already in hand for the second half of January to support such a projection.

From this perspective, there is significant risk of overreacting to incoming data, which even under the greenbook's rosy scenario would continue to show weakness before the effects of the recent easings and lower oil prices take hold. Problems in interpreting such data will be particularly acute over coming months, if in accord with yesterday's reports of CNN effects the data are distorted by the impacts of temporary disruptions to demand from the events of the Persian Gulf. While an insurance policy against a shortfall in the economy can in theory be resold if necessary through a subsequent tightening of policy, such moves are always difficult, and will be made even more so this time by the poor condition of financial institutions, which is likely to persist for a time even in a rebounding economy.

If the Committee had concerns on both sides of this issue, one way to encompass them would be to refrain from further easing at this time, retain the asymmetrical language, but still temper to an extent the response to incoming data. No change in reserve pressures at this meeting would recognize the extent of the policy actions over the last intermeeting period and a desire to let them filter a bit more through financial markets and get a better fix on the trajectory of the economy and prices; asymmetrical language would acknowledge that the risks were still seen on the downside, that the Committee wished to remain especially alert to evidence that a steep slide in activity was continuing, and that as a consequence, if an action were taken before the next meeting, the Committee would expect it to be an easing move; but in light of the size of the recent actions and the difficulty of sorting through incoming data, the Committee might want to allow evidence of unexpected weakness in the economy or shortfall in money to build for a time before reacting.